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Greece: Light at the End of the Tunnel

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Where does Greece stand today, six years after the outbreak of a severe economic crisis, which has led to drastic social repercussions and contributed to major political changes in the country? Key questions are being asked in public debates: If Greece requires a third rescue programme, what compliance requirements should be included, and how would such a programme be financed?

Greece has been a member of the euro zone since 2001. Cheaper mortgages, reduced yields on sovereign debt, and a rapid increase in public sector employment were key drivers of modernisation processes in the country's economy and society after accession to the euro zone.

In these presumably "good years" were the underlying causes for the country's emerging economic crisis in 2008, which was followed by the onset of the sovereign debt crisis in 2010. The structural deficits in Greece's economy, already apparent in 2004, were temporarily overlooked, or even outright ignored. The rapid economic upturn during the first decade of the new millennium was not sustainable. It was credit-financed and centred on imports and private consumption.

A decade later, both the economy and society of Greece are at a crossroads. The direction that the country chooses shall clarify if the current reform process can be sustained after the troika of international lenders (the International Monetary Fund [IMF], the European Commission [EC] and the European Central Bank [ECB]) stops exercising compliance pressure. It remains to be seen whether better (economic) times will appear on the horizon. There are equally good reasons to be both cautiously optimistic as well as sceptical about Greece's future course.

The Situation in Mid-2014

At the beginning of 2014, Greece held the rotating European Union (EU) presidency for six months. The presidency offered the political elites in Athens the opportunity to highlight the achievements of the macroeconomic reform process begun in 2010 to a broader European public that continues to have reservations about the country's progress.

According to data published by the Greek statistical agency, ELSTAT, after six years of a severe recession, various indicators are signalling a gradual turnaround in the real economy. In the second quarter of

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2014, the Greek economy contracted by 0.3 per cent (compared to Q2-2013), suggesting that a return to positive growth territory is within reach.

The emerging economic stabilisation is primarily the result of a successful year for tourism (in 2013 more than 18 million tourists visited Greece, a record level) and the international demand for container shipping, for which Greece is a major provider. But this recovery is still too fragile across other sectors of the real economy and has yet to reach the centre of Greek society.

The social costs of this economic adjustment process are staggering. In the foreseeable future, more than half of those employed will not be in a position to regain their income levels from before the crisis. Sustainable improvement in the Greek labour market is not yet visible. Those who do find work are frequently subject to precarious employment conditions. The Greek central bank is forecasting that the registered unemployment rate will remain stagnant above 26 per cent in 2014. In June 2014 registered unemployment reached 27 per cent, whereas the unemployment rate for youths (under 25 years) stood at 51.5 per cent – the second-highest level in the euro zone after Spain.

The challenges that Greece continues to face remain enormous. The macro-economic adjustment process, under way since May 2010, has achieved impressive fiscal consolidation. For the first time in a decade, Greece registered a primary budgetary surplus (before interest payments) in 2013. The economy's competitiveness was improved through a dramatic reduction in the current account deficit, chiefly by curtailing imports.

This progress is being challenged by persistent deficits in other policy fields. Increases in the country's export capacity have failed to materialise. In July 2014 exports declined by 1.1 per cent compared to July of last year (including oil exports). Improvements in the economy's productivity levels are the result of deep wage cuts and the consequences of mass unemployment. The high interest rates that domestic banks charge for investment credit are neutralising these productivity gains. Domestic consumption remains weak and is failing to position the economic recovery on a broader scale across Greek society. Foreign direct investment in the real economy is stagnating, not least because the privatisation process lacks support from large constituencies in Greek society. The divestment process is also frequently subject to political controversies and hampered by administrative delays and judicial proceedings.

Political Risk Factors

Although the process of economic stabilisation is under way, Greece is confronted with a variety of political risk factors. In June 2012 a two-party coalition formed between the conservative New Democracy (ND) and the left-of-centre PASOK and is led by Prime Minister Antonis Samaras in Athens. By mid-2014 its original majority of 30 MPs had shrunk to four due to a combination of resignations, changing sides, and exclusions.

The elections to the European Parliament in May 2014 reinforced the trend of political polarisation in Greece. For the first time, the largest opposition party, the radical-left Syriza, managed to win elections. Despite its success, Syriza's share of the vote stagnated, reaching 26.55 per cent – a fractional decline from its level of 26.89 per cent attained in the national elections of June 2012.

The governing ND was 3.9 per cent behind Syriza in the European elections. Together with its junior partner PASOK, the governing coalition reached 30.7 per cent. That share of the vote enabled the Samaras government to claim that it had not lost the elections and continue with its mandate. On the basis of this result, no party would be in a position to form a government in Athens today. Politically rather unrealistic – even if mathematically possible – would be a "grand coalition" between Syriza and ND.

Since the back-to-back general elections of May and June 2012, the party political landscape of Greece has been completely uprooted. The decades-old patronage system has collapsed. The governing parties are not in a position to sustain clientelistic networks anymore, for example by promising employment in the public sector in exchange for voters' allegiance. Consequently, the political centre in Greece has imploded.

The fascist Golden Dawn (GD) has benefited from this implosion, managing to gain third place in the European elections. With its share of the vote at 9.4 per cent, GD was able to relegate the governing PASOK to fourth place. With a focus on migration, law and order, and the emphasis on foreign domination by the troika and Angela Merkel's government in Berlin, GD succeeded in tapping into frustrations and anxieties in Greek society. GD is increasingly adept at converting the pool of protest voters into a permanent electoral base. To date, neither the governing coalition nor the other opposition parties have been able to formulate a convincing political strategy on how to confront the challenges presented by GD.

In February 2015 the mandate of Greece's president, Karolos Papoulias (born in 1929), expires. If the current parliament cannot succeed in voting for a new head of state with an extended majority of 180 votes out of a total of 300, then the Hellenic constitution calls for the dissolution of parliament and early general elections. At present, the governing ND-PASOK coalition only has a majority of 154 seats.

The largest opposition party, Syriza, has repeatedly announced that it will not nominate a candidate of its own, nor will it support a contender proposed by the governing coalition. In taking this no-compromise position, Syriza seeks to establish the leverage necessary to trigger early elections in 2015, provided the political polarisation in the Greek parliament remains.

Greece and the Troika

On 2 September 2014 the quarterly evaluation mission of the troika with the Greek delegation resumed in Paris. The choice of location sought to signal that a normalisation of the working relationship between both sides is in play. In selecting the French capital, participants also wanted to reduce the political tension that is inherent in the standard evaluation missions of the troika when visiting Athens.

The troika of international creditors is gradually readjusting its activities. This is due to the fact that the European-funding part of the second macro-economic adjustment programme expires at the end of 2014. IMF financing for Greece is scheduled to continue until early 2016. In the meantime, the examples of Ireland and Portugal have attracted followers in Athens. Dublin successfully exited its troika programme in December 2013 and was followed by Lisbon in May 2014.

The financial diplomats from the troika initially agreed with the Greek authorities in 2010 and 2011 about the implementation of a comprehensive structural reform agenda in exchange for the provision of credit facilities worth billions to stave off imminent default – both rescue programmes have a total value of 240 billion euros. With this bailout arrangement, all parties involved moved into uncharted territory for dealing with a euro zone member. As became quickly apparent, the willingness of Greek authorities to implement sweeping structural reforms had political limitations. By the same token, the chemistry between the three troika institutions was a permanent work in progress.

In a May 2013 ex-post evaluation of Greece's first rescue package, the IMF highlighted major flaws in its approach, projections, and programme execution. The IMF came to the conclusion that the programme conception was erroneous, the administrative capacities of the Greek civil service to implement the agreed benchmarks were overrated, and the structural deficits of the real economy proved to be much deeper than initially assumed. Based on assumptions that were far too optimistic, the troika failed to identify the dramatic increase in unemployment, nor did it accordingly project the disruptions to the real economy, which provoked a much longer recession than had been estimated in mid-2010.

For 2014 the IMF expects a debt-to-GDP ratio for Greece of more than 174 per cent. Such an amount would surpass the sovereign debt levels attained in 2011, that is, *before* the two debt-restructuring operations of 2012. Without both debt-reduction manoeuvres, Greece's total indebtedness would today be in the range of 380 billion euros, roughly equivalent to 208 per cent of annual GDP.

The two rescue packages for Greece from 2010 and 2011 – in combination with the debt-restructuring exercise and the debt buy-back operation of 2012 – have together contributed to a significant transformation in the configuration of Greece's debt volume. Today more than 85 per cent of the sovereign's obligations are held in portfolios and budgets of official creditors. In mid-2014 the euro zone member states, the ECB, the IMF, the European Financial Stability Facility, and the European Stability Mechanism are the key guarantors of Greece's sovereign debt. This liability exposure of official creditors is the result of unprecedented debt migration from the private sector to public institutions. This reprofiling of Greece's sovereign obligations makes any future debt restructuring an exercise that would almost entirely impact the official sector of Greece's creditors.

The second macro-economic adjustment programme of Greece with the troika includes a provision in which the country's debt mountain has to be reduced to 124 per cent of GDP by 2020. There are, however, serious doubts about the attainability of this objective. After six years of recession, Greece's growth potential is too weakened to generate the levels of GDP performance necessary to achieve this ambitious debt-to-GDP ratio. The projections by the European Commission provide for an economic recovery that reaches 0.6 per cent this year and a growth rate of 2.9 per cent in 2015.

It is also by no means self-evident that Greece will be able to achieve a primary surplus in its central budget every year, preferably with incremental increases in volume. Bringing the debt volume down to sustainable levels by stretching the repayment timetable to 50 years implies burdening the next generation with a major liability. Moreover, Syriza has already announced that, in the event of it leading a government in 2015, the party will seek a profound policy U-turn. Syriza would reject fiscal austerity, fundamentally change working arrangements with the troika, and call for an international debt conference for euro zone countries, starting with Greece.

The Role of Greek Banks

In 2013 the four largest Greek banks (by assets) were recapitalised. Contrary to the origins of the crisis in Ireland, Spain, and Cyprus, the Greek financial sector did not trigger the sovereign debt crisis in 2010. Still, since the four largest domestic financial institutions were heavily exposed to Greek sovereign debt, the implementation of the debt-restructuring operation in 2012 adversely impacted on their balance sheets. As a result, they held negative capital adequacy ratios and were not in a position to raise additional resources on international markets. One option was the liquidation of the banks, with the concurrent implosion of the Greek financial sector; alternatively, saving the four largest banks through state-sponsored recapitalisation became the default option, despite major controversies surrounding this decision.

The four systemically relevant banks were recapitalised with 41 billion euros, which were provided from resources included in the second macro-economic adjustment programme. Today, the National Bank of Greece, Piraeus Bank, Alpha Bank, and Eurobank comply with financial conditionalities demanded by the troika and adhere to international capital adequacy ratio standards. However, this achievement should not be confused with the assumption that Greek banks now have enough resources to provide liquidity to the real economy. As a matter of fact, the credit crunch for private households and corporate entities continues unabated. The domestic lending institutions have not returned to their original mandate, that is, providing the real economy with affordable and timely credit facilities. This applies particularly to small and medium-sized businesses (SMEs), which are the backbone of the Greek economy.

Any attempt to put the economy back on a firm footing will only succeed when domestic banks can contribute to the cause. But to date, local banks continue to exercise considerable restraint when providing credit facilities to companies. The reasons for this reservation are not primarily due to the banks themselves, but originate in the balance sheet compliance requirements of the ECB's asset quality review (AQR) and stress-testing of European banks in the autumn of 2014.

As with numerous other European banks, the four systemically relevant Greek institutions are required to either de-leverage their risk-weighted assets or alternatively provision for these through higher capital ratios. In the balance sheets of local banks, credit provided to SMEs are rated as risk-weighted assets. In anticipation of the ECB's AQR and stress tests, banks have little incentive to burden their balance sheets with credit to struggling SMEs.

In light of persistent liquidity deficits in the real economy of Greece, interest rates on available credit for investment are far too elevated for companies to express any demand. To illustrate: A German medium-sized firm, which exports to south-east Europe and seeks a credit facility of 1 million euros for up to five years currently pays an interest rate ranging from 2.5 per cent to 4 per cent. By contrast, a Greek company that is export-oriented, despite a multi-year recession, faces credit charges between 6 per cent and 8.5 per cent. These are the highest lending rates since Greece joined the euro zone in 2001.

A normalisation of credit transmission channels through the Greek banking sector is urgently called for. The liquidity position of domestic institutions can only improve when two processes occur in tandem. First, following upgrades in their credit rating, Greek banks are able to return to international capital markets while simultaneously reducing their reliance on liquidity facilities from the ECB. Secondly, Greek banks must continue to strengthen their deposits. In the past five years, local banks have lost more than 30 per cent of their customers' deposits. This drain of liquidity has only gradually been reversed. Today, the problem is not capital flight. Rather, private households and corporate entities use their deposits to pay for mounting tax obligations and service-accumulated debt.

EU Funding and Financial Innovation

The financial engineering instruments available to Greece from EU funding programmes – structural funds, regional development fund, cohesion and social funds – have achieved a significant increase in absorption levels since 2011. In the course of the past four years, Greek managing authorities have made a determined effort to use these funding resources from Brussels. In December 2010 Greece ranked in 17th position among all 28 EU member states as concerned the rate of structural fund absorption. Only 21.86 per cent of all available funding facilities had been attracted. Four years later, the position of Hellas in the EU funding table has dramatically improved. By June 2014 Greece had moved into fourth position, with the absorption rate of structural funds reaching 81.26 per cent.

This turnaround is the result of various factors, not least the collaboration of Greek authorities with representatives from the European Commission's Task Force for Greece (TFGR), which has been active in

Athens since 2011. The TFGR's key tasks are to provide and coordinate technical assistance for Greek ministries and regulatory authorities. The TFGR (for which the author of this contribution worked for two years) was established following a request from then Prime Minister Giorgos Papandreou in mid-2011. The Commission in Brussels created the TFGR in order to improve the capacity of public administration to implement the compliance requirements stipulated in the second macro-economic adjustment programme.

The World Bank, the Organisation for Economic Co-operation and Development or the World Health Organisation provide technical assistance in cooperation with member states of the EU and the Commission in Brussels. Together they formed an institutional network of applied solidarity with Greek authorities and focussed on capacity-building as well as implementation and monitoring of the structural reform agenda. The TFGR coordinates the network of technical assistance, helps in identifying bi- and multilateral project promoters and reports about its work streams such as tax administration, health services, procurement and fund absorption on a quarterly basis to the public in Greece and within EU institutions.

The significant improvement in the absorption capacity of EU funding programmes by Greek authorities is also the result of administrative changes at the Commission level. In 2011 the Brussels executive granted Greece a reduction of its co-financing share in EU-funded projects – from the initial level of 15 to 20 per cent to the new level of 5 per cent. In addition, different Directorates-General of the Commission acknowledged that the country's severe economic recession required more administrative flexibility in the management and regional distribution of EU funds.

A second institution has also made a significant contribution towards alleviating the situation on the ground. The financing arm of the European Commission – the European Investment Bank (EIB) in Luxembourg – is the single largest foreign direct investor in the real economy. In 2013 the EIB invested upwards of 1.47 billion euros. The credit facilities of the EIB focus on infrastructure projects such as the extension of the Athens metro, the construction of the new Thessaloniki metro, tourism promotion, initiatives combating youth unemployment, motorway construction, etc.

The higher absorption levels of EU funding programmes and the investment activities of the EIB are much-needed sources of liquidity-injection into the Greek real economy. Both financing facilities have a pro-cyclical effect and contribute to stabilising the emerging economic recovery. Moreover, they compensate for the lack of liquidity provisions from private sources, local banks and constrained resources in the public investment budget.

However, we should not lose sight of a potential risk inherent in such funding arrangements. In the medium-term, EU funds and EIB credit facilities cannot continue to substitute for the lack of domestic investment and compensate for the dearth of foreign direct investment. There is a risk that a mentality of dependency from European funding institutions prevails across the Greek economy.

Furthermore, the successful absorption of European funding facilities is primarily focussed on large infrastructure projects. But on the ground, SMEs are having a much harder time gaining access to EU funding programmes. The obstacles they face are administratively arduous and time-consuming. During the 2007–2013 EU financing period, Greece only absorbed an astonishingly low 6.4 per cent of all available structural funds earmarked for SME financing.

These funding programmes focussed on making investment capital available to SME development in Greece. But under the conditions of a multi-year recession, most SMEs need operational capital in order to finance their current activities. The Commission in Brussels was rather restrictive in providing such financing options. Instead, it underlined that the 2014–2020 funding period would offer working capital schemes. But until these facilities are fully operational, much administrative time will have passed and may arrive too late for eligible SMEs.

In order to confront this challenge, a major financial innovation has recently been developed in Greece. After time-consuming negotiations with the troika about its investment mandate and funding arrangements, the legal preconditions were passed by the Greek Parliament in December 2013 to create the Institution for Growth (IfG).

The IfG is an investment fund mandated to provide liquidity to the real economy. One of its sub-funds is focussed on investing in Greek SMEs. Although the IfG will operate in Greece, it was registered in Luxembourg. Its initial capital is a combination of various sources, ranging from the budget of the Hellenic Republic to a contribution from the Onassis Foundation. In addition, the German Federal Ministry of Finance contributes – via its development bank KfW – 100 million euros in start-up capital, mainly earmarked for SME financing.

Does Greece Need a Third Programme?

Representatives of the Greek government have repeatedly emphasised during the past months that the country does not require a third financial support programme. They argue that in April 2014, Greece successfully returned to international bond markets after a three-year forced hiatus. Furthermore, the primary surplus achieved in 2013 – and the one expected for this year – underline that the government in Athens is in a position to finance its current expenditure requirements.

The current troika negotiations are concentrated on the evaluation of the structural reform requirements. In the later stages of these consultations, the complex issue of Greece's debt sustainability will be addressed. The outcome of these consultations will determine if Greece requires a third programme.

If such a programme were to materialise, what could be its key elements? As a point of departure, the terminology would have to be carefully crafted. The term "memorandum" has been negatively associated with the two preceding programmes and is linked to a period that Greeks want to leave behind as quickly as possible.

Clear conceptual and methodological demarcation lines will have to be drawn compared to its predecessors. A stringent focus on fiscal consolidation and the stability of the banking sector – important in their own right – cannot continue to define a new support programme. Rather, such a "cooperation agreement" would have to consider how Greece could be institutionally supported in its reform endeavours. The focus now turns to the challenge of how the implementation of a new growth agenda can be made permanent and irreversible.

In order to strengthen the reform impetus in the Greek political economy, it is necessary to broaden the focus of current deliberations. The European creditor community must move beyond the consideration of further interest rate reductions or maturity extensions on the official loans provided to Greece. Rather, a cooperation agreement with Athens would emphasise the implementation of a new growth agenda. Critically, any agreement needs to have greater support among Greek citizens and participating institutions. Five key reform areas are herewith proposed:

- At the horizontal level, the programme would have to formulate cross-cutting issues that affect all sectors of the real economy, in particular as regards domestic and foreign investment capacity. One area where implementation delays and administrative deficits are distinct concerns the privatisation process. Issues such as the valorisation of public property and the capacity to construct securitisation arrangements for these assets deserve greater attention. This approach argues in favour of long-term leasing arrangements and greater leverage in the corporate management of public property.

- In order to promote Greek export capacity, arrangements at the bilateral and/or European level should be explored that facilitate the availability of export insurance guarantees for Greek companies. The further rationalisation and digitalisation of customs procedures is part and parcel of such an export promotion policy.
- For new businesses, including start-ups, the availability of micro-finance structures needs to be advanced in Greece. Frequently, new SMEs do not lack innovative ideas but seed capital, which such start-ups continue to have great difficulty receiving from their local banks. A targeted implementation of European funding programmes and technical assistance that lays the groundwork for micro-finance structures in Greece is necessary.
- A new cooperation agreement with Greece should focus on institutional capacity-building. This requires fine-tuning the coordination of technical assistance provided by international stakeholders and increasing the participation of expertise from Greek institutions. Instead of debating if Greece needs further financial assistance in the form of lending programmes, attention should turn towards facilitating the financing of technical assistance for Greece.
- The possibilities for combining existing financing options for Greece have not been exhausted. This view does not call for additional official credit lines for the country. Preferably, it advocates strengthening synergies between different funding programmes and institutions, for example by seeking to enlarge the group of financial backers of the IfG with additional countries, banks, and international organisations. The integration of new funding partners into the IfG would broaden its operational capacity and open new avenues for SME financing.

Looking Forward

The fragile economic recovery manifesting itself in Greece needs to be anchored across a broader scale of sectors, domestic consumption, and investment volumes. This endeavour is facing old obstacles and new headwinds. The sanctions regime adopted by the European Commission against Russia adversely affects the Greek export industry, in particular the agricultural sector. A further consequence of counter-sanctions could be a decline in tourist arrivals from Russia.

New challenges following geopolitical disruptions are literally arriving at Greece's doorsteps. The refugee influx from Syria, Iraq, and the Maghreb are overstraining the administrative capacities of Greek border institutions. Since the beginning of 2014, the Greek border authorities have registered more than 17,000 new refugees. The government in Athens has urgently asked the European Commission to provide additional funding resources for improved cross-border management, the construction of reception centres for refugees, as well as quicker registration procedures.

The structural adjustments currently under way in the Greek political economy are profound and have incurred high social costs. Adhering to the fiscal consolidation imperatives of the troika has given rise to non-intended consequences in terms of mass unemployment, the implosion of domestic consumption, and a prolonged credit crunch in the real economy. It will take time until structural reforms take effect and gain traction.

The key objective of decision-makers in Greece and its European partners remains the improvement of social cohesion and ameliorating the operational conditions for a sustainable economic recovery. Removing obstacles along the way remains a herculean task. The manner in which solidarity with Greece manifests itself in the near future critically depends on the stability and predictability that the government in Athens displays in the coming months.

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